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INVESTMENT IN THE DEVELOPING WORLD: DEMOCRACY AND/OR TRANSPARENCY

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By John Andrew Carter, Jr.

A thesis presented in partial fulfillment of the requirements for completion
of the Bachelor of Arts degree in International Studies

Croft Institute for International Studies
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ABSTRACT

INVESTING IN THE DEVELOPING WORLD: DEMOCRACY AND/OR TRANSPARENCY

This thesis examines the concept of transparency and its role in international investment in the developing world. Investment is essential to developing nations because of its overarching economic benefits, such as new avenues of employment, exposure to new markets and the financing of diverse development projects. The desire for increased capital from foreign investors has influenced and shaped the economic policies of developing democratic and autocratic states. One of the most recent trends in economic policy is the formulation and adoption of transparent vehicles, such as access-to-information legislation, which address perceived investor risk through certain actions, such as publishing various economic statistics about a certain market or economy. Perceived investor risk is accompanied by commitment and information problems when multinational corporations engage in investment negotiations with a developing state. While democracy is acknowledged among scholars such as Nathan Jensen to alleviate the commitment problem in negotiation, the scope of this thesis focuses on transparency and its role in addressing the information problem in the facilitation of multinational foreign direct investment. The empirical analysis shows that the degree of transparency is not contingent on the presence of democracy in a particular state and both autocratic and democratic regimes have similar advantages in the competition for investment. The results also highlight the increased dependency on transparency vehicles by autocratic regimes because the regime itself is unable to counter certain facets of the commitment problem due to the lack of democratic means of governance.

Keywords: foreign direct investment, transparency, multinational firms, investor risk, developing nations, development, democracy, autocracy

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INTRODUCTION

The process of globalization has accelerated the rate of communication and information transfer via advances in technology and the expansion of the Internet. Globalization is the reduction of economic, political and cultural exchange barriers by technological, economic and political innovations (Drezner 2001: 200). Undoubtedly, globalization has united the world economy and created vast networks of business spanning across national borders. As a result, new economic opportunities are surfacing around the world through the connection of producers to foreign distributors, assemblers to foreign suppliers and investing firms to potential host nations (Rauch & Trindade 2003: 775).

The aforementioned economic opportunities are created in the international economy through investment ventures facilitated by private firms. Arguably, the opportunities accompanying foreign investment are more vital to developing nations because of the potential economic benefits, including new avenues of employment, the exposure of domestic producers to new markets as well as an increase in liquid capital used to finance diverse development projects. Firms are attracted to the developing world because of the ability to access abundant and inexpensive resources and factors of production, both of which can potentially lower the firm's overall cost of production. However, there are two uncertainties that inhibit both parties from engaging in investment: the problem of ensuring commitments and guaranteeing the transfer of accurate and relevant information.

This thesis serves the purpose to provide a better understanding of which states will receive foreign investment flows. The impending research embodied throughout

this thesis will further dissect the informational uncertainty presented in the negotiation of investment by multinational firms and developing states by evaluating the concept of transparency and assessing its role in international investment flows to the developing world.

This chapter will introduce the scope of my research through explaining how and why I chose to research the underlying problems of investment, the research design models and to convey a brief outline of the remaining chapters of this study.

During my undergraduate studies, I was fortunate to spend a semester abroad in Europe. Through my travels, I encountered various American brands and enterprises that were expanding their activities in Eastern and Western Europe. American clothing companies such as Carhartt and Levi Strauss utilized their foreign presence to reinvent their brands in order to attract European youth consumers. Fast food restaurants such as Kentucky Fried Chicken and Burger King followed a similar marketing strategy and successfully associated their products and services in Europe with a renowned sense of quality and prestige. Even Anheuser-Busch rebranded their premium brew, Budweiser (known to Europeans simply as “Bud”) in order to adapt and appeal to the new consumer market as a premium import lager.

With additional research, I found even more brands that modernized and implemented an alternative ego overseas. After taking a class on the international political economy upon my return to the US, I became interested in the central motivations of firms to implement cross-border operations as a means to reinvent their products in new consumer markets. The coursework identified the potential externalities that stem from foreign investment, especially in the developing world. After assessing the investment flows and its subsequent concentration in advanced

industrial economies, I was compelled to investigate why multinational firms do not concentrate their investment in the developing world.

Research Design

The research question guiding this thesis is, “What uncertainties inhibit firms from pursuing investment ventures in the developing world?” This is important to understand because investment can facilitate development and economic expansion in a particular developing economy. The reduction of uncertainty and risk in investment negotiations results in increased investment opportunities.

This thesis relies on literature on foreign direct investment (FDI) as well as the problems presented to investors and potential host nations throughout the duration of the negotiation process, such as a problem of ensuring commitments and appropriate information transfer. These topics help distinguish the significance and vitality of investment in developing nations. Analyzing existing literature on the problems of investment sheds light on the potential steps necessary to alleviate or reduce the uncertainty and risk of firms and states. Scholarship on foreign investment by notable scholars such as Nathan Jensen (2003, 2006, 2008), suggest a positive relationship between democracy and investment. While Jensen explains democracy to serve as a precursor to investment, why do autocratic regimes still receive investment flows? Other literature, such as the work of political scientist Daniel Kono (2006), supports the notion that the presence of democracy can actually decrease the probability of multinational investment due its protectionist legislation, strict corporate regulations, political accountability and term limits.

If democracy cannot singlehandedly answer the problem of information transfer between negotiating parties, what other variables could serve as a prerequisite for

investment? I attempt to answer this question by (1) studying the potential externalities of investment in the developing world, (2) examining the role of democracy in investment negotiation, and (3) offering a new prospective on how to counter the uncertainties of investment.

By identifying what drives investment, it is easy to predict which states will receive increased investment flows. Based on this method of analysis, I predict to find a robust positive correlation between the levels of investment among parties that employ various transparent vehicles, such as access-to-information legislation. Transparency, therefore, can alleviate the problem of information in investment because of the implied availability of economic and political statistics among transparent states or firms.

Data and Methods

This thesis analyzes quantitative data on foreign direct investment to predict which states will receive increased investment flows. In order to do so, this thesis examines the degree to which a state is democratic, the degree to which a state is transparent, total population, gross domestic product (GDP) per capita, as well as the rate of GDP growth.

Democracy can be empirically evaluated using the Polity IV dataset, which scores states based on the presence of democratic means of governance. The degree to which a state is transparent can be empirically measured by constructing a ratio of the number of statistics reported by a particular state to international institutions, such as the World Bank and International Monetary Fund. Each year, the World Bank Indicators serve as the official statistics on the population, GDP per capita and rate of GDP growth of internationally recognized states.

Through OLS regression, I will test each variable in order to discover which variables are statistically significant in terms of increased FDI inflows. I will also empirically evaluate the dependency of non-democratic regimes on transparency vehicles because of their inability to counter the commitment problem due to an absence of democracy. The analysis will gage the importance of transparency in the allocation of FDI among various regime types throughout the developing world.

Thesis Structure

Chapter one, Firms and Investment, provides necessary background information on the history and emergence of multinational firms, their role in the international economy, the current investment atmosphere, as well as the source and concentration of FDI flows.

Chapter two serves as a review of previous scholarship on FDI. In this chapter, I will explore and analyze existing literature on the externalities of foreign investment, reservations presented in investment negotiations, and the insufficiencies of democracy to alleviate the problems faced by states and firms. Although my assumptions presented in this thesis are primarily based on the economic aspects of FDI, I will also explore the literature on the political factors motivating FDI because it helps to better understand the broad impact of the presence of multinational firms in developing states.

Chapter three outlines my central theory about transparency serving as a possible prerequisite in investment negotiations. In this chapter, I give the basis to my argument that transparency and democracy are not the same. At the end of chapter three, I will present my hypotheses about transparency driving investment in the developing world and the increased dependence on transparency vehicles by autocratic regimes.

In chapter four, I will present my empirical analysis and methodology. I will statistically test both of my hypotheses outlined in the preceding central theory section and evaluate the levels of foreign investment flows and its dependency on the degree to which a state is transparent.

The concluding chapter of this thesis, chapter five, will provide a discussion and final assessment of my research. I will formally present my conclusions and propose possible explanations for predicting which states will receive FDI. Predicting FDI flows sheds insight on the development and consequent expansion of multinational firms in the developing world.

CHAPTER 1

FIRMS AND INVESTMENT

Enhanced by new means of communication, the exposure and subsequent integration of global markets have introduced the world's biggest economic entities to economic opportunities in developing nations. The term "developing" is misleading and not contingent on the development status and modernization of a specific country. The World Bank categorizes member nations and other economies with more than 30,000 people as "developing" if the gross national income (GNI) per capita is less than US\$4,085 (World Bank 2014). GNI per capita is the total output by citizens of a particular nation, consisting of gross domestic product (GDP) minus incomes of non-citizens in that domestic economy (Todaro & Smith 2011: 44). Because of the inability to finance costly economic development projects, lower income countries seek aid from developed nations, non-governmental organizations or more importantly, through avenues of investment by foreign firms in their domestic economy.

Private firms with an international presence are the facilitators of foreign investment, which is the total net worth of a firm's assets held abroad. These firms, often referred to as multinational corporations, are proliferating throughout the global economy. A multinational firm is a single corporate structure that controls and manages methods of production or financial assets in at least two different countries. Through foreign investment, firms extend managerial control across national borders and make decisions based on global market strategies to ensure corporate success and profitability. The benefits of global expansion by firms include eased operations around the globe, reduced costs of production, tax incentives, market expansion, bypassing trade barriers and increased access to resources (Oatley 2012: 158-9).

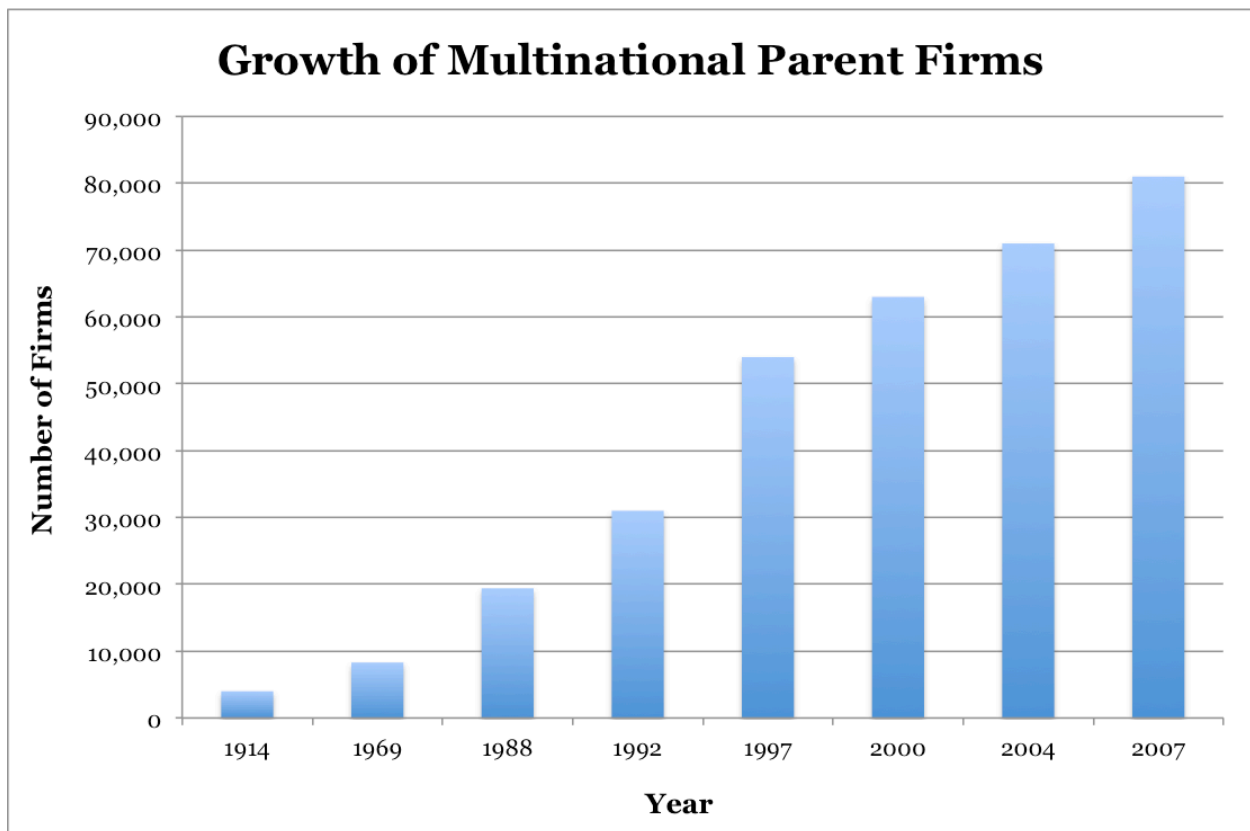
Multinational firms emerged as a main component of the international economy during the late 19th centuries amid extensive colonialism. Investment often mirrored colonial ties and helped increase the influence and dominance of global entities in their respective colonies by taking direct control over crucial sectors of their economy (Frieden 1994: 129). This is best exemplified through the global trade and commerce generated by some of the earliest multinational firms, such as the British and Dutch East India Companies.

Leading up to World War I, private firms from economic superpowers such as Great Britain and France invested in public utilities such as railroads, water and power plants and urban transportation throughout developing regions, such as in Latin America, East Asia and Africa (Frieden 1994: 127). For example, in 1948 British architects designed, financed and constructed the first railway in South America in British-held Guyana as an effort to transport sugar from the Demerara Sugar Company over the Mahaica River, to the docks of Georgetown (Guyana 2014).

The expansion of multinational activity throughout the late 20th and early 21st centuries was a result of the mounting foreign influence and consequent economic prosperity in current and former colonies. The number of private firms without colonial ties increased their presence in the developing world because of the gradual integration of global markets and increased trade. International trade aided the circulation of products and resources around the globe. For example, by the 1970s, firms from the United States began competing with established firms headquartered in Great Britain for investment opportunities around the globe in chemical, pharmaceutical, electric, machinery, automobile, tire and processed food industries (Oatley 2012: 160).

The amount of firms internationalizing their activities in the global economy has increased dramatically in the past 30 years. In 2008, the number of firms with overseas operations was eleven times more than the number of existing firms in the early 1980s. Today, over 80,000 firms own almost 700,000 affiliates in almost every country in the world (Jensen 2006: 24). Multinational corporations account for over 30% of global exports and employ over 77 million people around the world (United Nations 2009: xxi).

Figure 1.1: Number of Multinational Corporations



(Source: Oatley 2012, 160; Gable & Bruner 2003, 3; UNCTAD 2009, Annex Table A. 1.8)

Figure 1.1 emphasizes the expansion of the activities of private firm in the international economy by showing the steady growth of multinational firms since 1914. According to the graph, the number of firms with operations in multiple countries fell

just short of 5,000 in 1914 and increased to about 80,000 by 2007. This increase over time indicates the integration of the international economy amid the expansion of multinational corporations.

As more private entities increase their presence abroad, their significance in the global economy enhances. To understand the impact multinational firms play the international economy, the methods in which firms internationalize their affairs must be understood. There are two outlets of investment for firms: portfolio and foreign direct investment (FDI).

Portfolio investment is the process by which firms purchase shares of a particular state's stock market or by investing in government bonds, which is also known as sovereign lending. Portfolio investments transfer capital from the firm to the host nation. Foreign-held portfolio assets are more liquid and relatively mobile for foreign investors. Under portfolio investment, investors are primarily concerned with the return rates, inducing a minimized, indirect control over the investment in the host economy.

Foreign direct, or equity investment consists of purchasing or constructing physical property and equipment abroad. FDI is a product of a private firm's strategic decision to internalize activities within a firm in ways that surpass political and national boundaries, in search for new methods of production and sources of profit. Direct investment also includes profits of foreign affiliates that are reinvested rather than repatriated to parent firms and enterprises. The overall value of FDI is measured at the historical cost of the asset, which indicates its initial value. Figures on FDI can be deceptive because they do not fully represent the current market value, which can

fluctuate due to external factors such as changing exchange rates, inflation or depreciation (Walter & Sen 2009: 173-4).

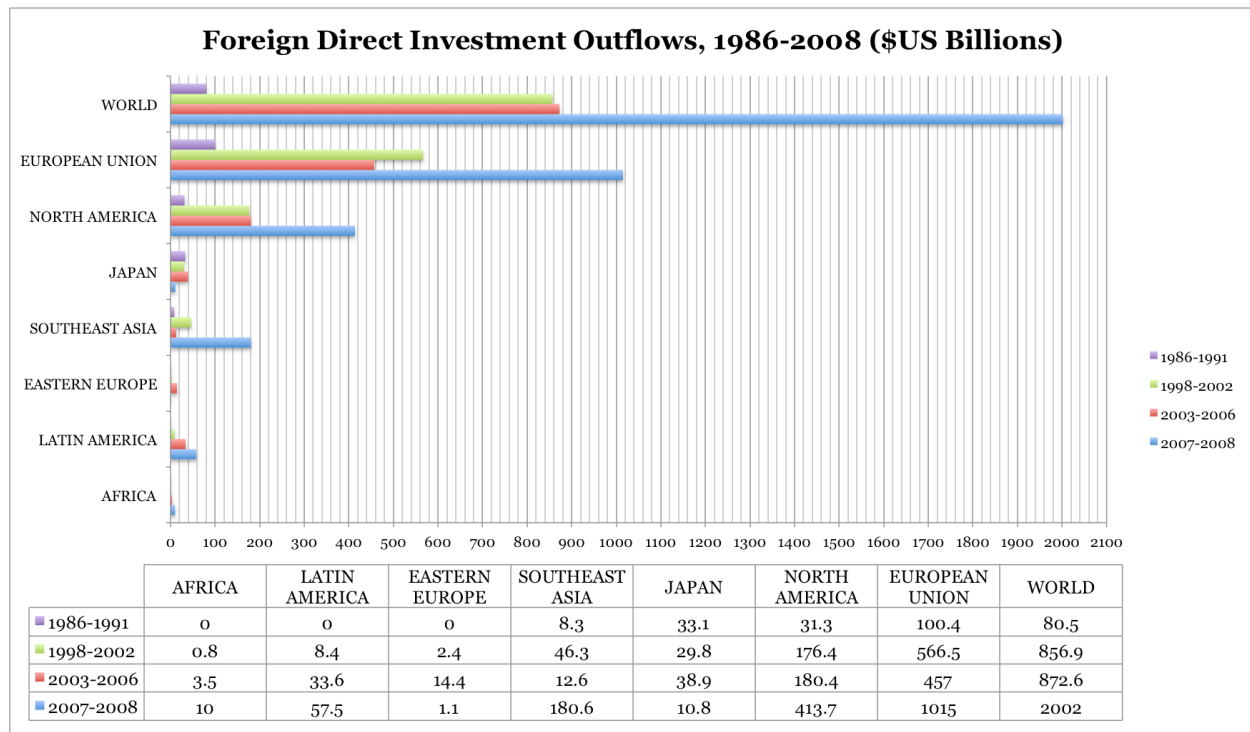
Unlike portfolio investment, FDI is active and highly immobile, requiring a long-term fixed investment that is not easily liquidated. Direct investment is when a parent firm owns at least 10% equity in the foreign affiliate (Walter & Sen 2009: 173). This type of investment enables multinational firms to control portions of their assets, rendering FDI as a source of authority within a foreign economy. The remainder of this study will focus solely on investment classified as foreign direct not only because of its immobile status and implied multinational control, but also because of the potentially greater influence and applicability of transparency presented in FDI (formally presented and hypothesized at the end of chapter 3 and empirically tested in chapter 4).

Foreign direct investment has become increasingly popular over time. FDI, unlike loan packages or governmental aid, is multi-faceted in the sense that the investment is sustainable and has the potential to mutually benefit both the state and the multinational corporation (Drabek & Payne 2001: 5). Because of the mutual benefits, investment outflows have been on the steady rise. In 2008, FDI amassed to US\$16.2 trillion, an increase of 2,300% since 1980 (United Nations 2009). The increase of FDI produced higher growth rates than the global GDP from 1986 through 1989 and again in 1995 (Drabek & Payne 2001: 5).

It is important to know the source of FDI in order to examine its effects throughout the global economy. The bulk of FDI is supplied by advanced industrial economies. Over 90 of the 100 largest multinational firms are headquartered in the United States, Western Europe or Japan (Oatley 2012: 162). In 2008, advanced industrial economies were responsible for over 81% of the US\$16.2 trillion world foreign

direct outflows (United Nations 2009). Since 1999, the United States, Luxembourg, United Kingdom, France and Germany have dominated FDI outflows (Walter & Sen 2009: 177).

Figure 1.2: FDI Outflows



(Source: United Nations 2009)

Identifying investment outflows by region indicates the proportion of assets in the international economy owned by firms headquartered in a particular region.

Figure 1.2 identifies the nominal FDI outflows from various regions of the world since 1986. According to the graph, the majority of outflows come from the European Union and North America. Combined, both regions supplied over 70% of FDI in 2007 and 2008. Latin America and Africa did not supply FDI in the late 1980s and early 1990s but have since shown a steady increase in FDI outflows.

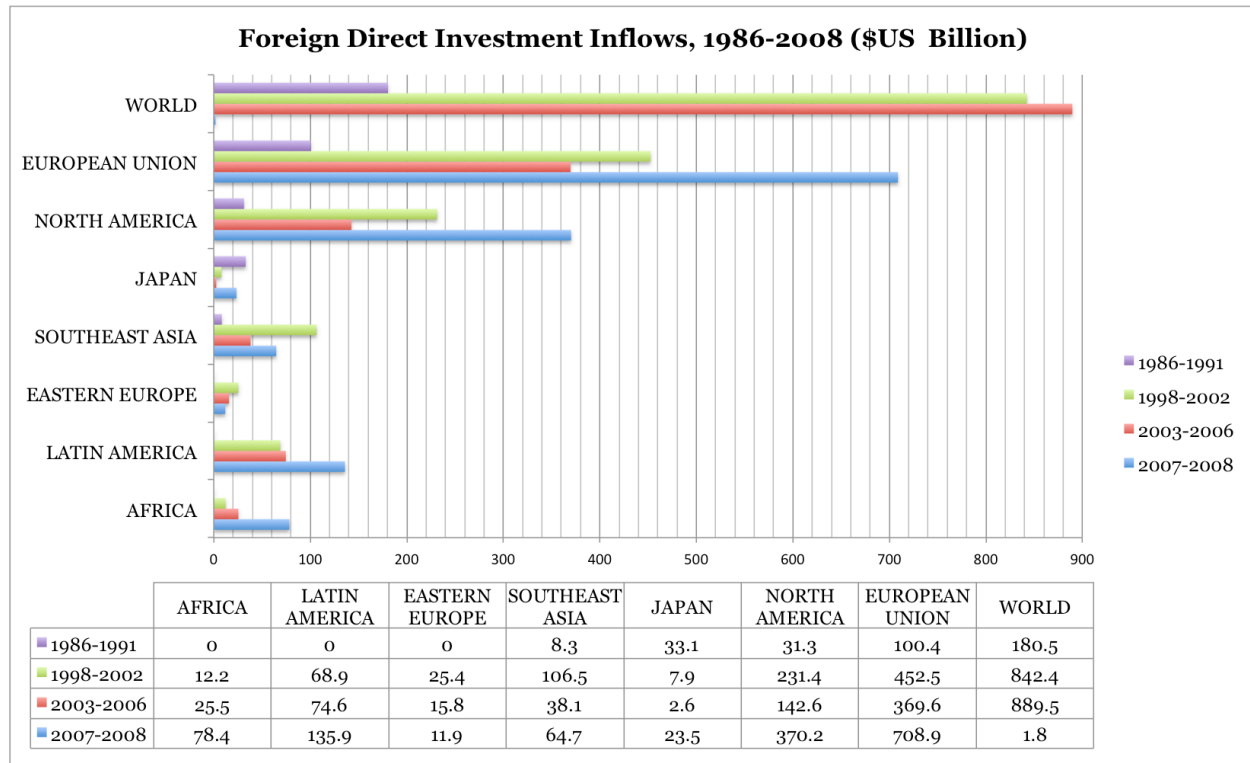
Even though advanced industrial economies supply the bulk of foreign investment, the majority of investment flows are not concentrated in the developing world. Despite the fact that multinational firms facilitate global operations, the majority of their activities are centralized in other high-income, developed nations. This is surprising because the largest recipients of FDI are other advanced industrial economies, such as the United States and various nations in the European Union. Combined, the United States and European Union received more than 75% of the world's FDI throughout the 1980s and 1990s (Oatley 2012: 162-3). Both entities remain the dominant recipients of FDI, claiming 57% of foreign investment in 2008 (United Nations 2009). Increased competition for foreign investment in less developed countries can explain the slight decrease in their combined investment inflows since the late 1990s.

Multinational firms are becoming increasingly attracted to the developing world. The presence of multinational corporations in the developing world is the response to their imperfect domestic product and factor markets, such as insufficient supplies of land, labor or capital. The process of firms internationalizing their activities is also a direct response to governmental intervention and regulation in business proceedings such as taxation and the establishment of trade barriers (Walter & Sen 2009: 179).

Inflows to the developing world doubled from 1980 to 1997 to US\$190 billion, accounting for just under half of total foreign investment (Oatley 2012: 163). FDI in the developing world continues to increase, such as in 2008 when FDI inflows amassed to an astonishing US\$620 billion (United Nations 2009). However, FDI is not distributed equally throughout the developing world. The majority of investment is concentrated in a small number of developing nations, such as China, Brazil, Argentina, and Mexico, for

various economic, geographic and political reasons (Oatley 2012: 164). This serves as a prime example of the inadequate distribution of FDI and highlights the potential pitfalls or misunderstandings that can occur between investors and host governments in the establishment of investment.

Figure 1.3: FDI Inflows



(Source: United Nations 2009)¹

Figure 1.3 reveals the concentration of nominal FDI inflows broken down by various regions since 1986. Not only are the inflow statistics important in determining which states receive FDI, it is also important because it can help distinguish trends in certain regions regarding the allocation of FDI. Multinational firms can explore new economic opportunities in regions where multinational investment is on the rise. For

¹ The dissimilar 2007-2008 world value of FDI inflow, as compared to previous world output values, can be explained by economic recession and the scarcity of credit in the international financial systems.

example, **Figure 1.3** indicates an overall increase of FDI inflows in Africa, Latin America and North America since 1986, which could result in increased investment because of the presence of other multinational firms.

CHAPTER 2

REVIEW OF PREVIOUS LITERATURE

In order to understand the framework of my central research question about the uncertainties inhibiting investment in the developing world, I am most concerned with current literature on foreign direct investment; the problem of commitment and information in negotiation; as well as the applicability of transparency as an instrument in investment ventures. This chapter will explore and analyze the research and conclusions of previous scholars as a means to distinguish my hypothesis from existing published material.

The expansive presence of multinational firms in the developing world has a substantial impact on the domestic economies of host nations. Through the internationalization of their corporate activities, firms have the indirect ability to transform and improve existing financial systems of host nations, which has the potential to result in more complete, stable and better-regulated markets on a macroeconomic scale. The existence of sound financial systems fosters economic growth for developing nations because of its ability to monitor credit and play a role in the allocation of resources. The resulting byproduct of multinational investment is economic growth and stability and well-rounded financial market infrastructure, which enables borrowers and lenders to operate in a more competitive, efficient environment with minimal risk and maximum credit (Schmukler 2004: 316).

In order to initiate the development of sound financial systems, firms must first provide host nations with access to scarce factors of production: capital, technology, and managerial expertise. The positive externalities that stem from increased economic opportunities are particularly attractive to the developing world because they enable

firms to address each economic limitation through the creation of jobs and consumer bases, the accumulation of capital from a transfer in savings between countries, technological modernization, importation of industrial and managerial expertise, as well as the introduction of domestic producers to the multinational firm's global consumer network (Oatley 2012: 173).

The promise of capital, technological modernization, managerial expertise and global marketing networks comes at a price to developing nations. There is a growing consensus that implies that foreign direct investment (FDI) flows has a positive effect on domestic, national economies. However, multinational entities suffer negative portrayals among citizens and government officials in developing states regarding their role in the broader, international economy. Firms can pose as a direct threat to economic prosperity due to their ability to exploit dominant facets of the host nation's economy and thwart competition (Jensen 2006: 33).

Economic Opportunities

The presence of multinational firms in a developing nation produces economic opportunities to the host nation by employing its local citizenry and producers. The creation of jobs for the local citizenry aids in maintaining and improving the standard of living of the host nation. Multinational firms also employ domestic producers by consuming domestically produced goods and resources. By providing jobs and utilizing domestic products, multinational firms can directly stimulate the host nation's economy (Jensen 2006: 31).

Because multinational firms operate within a widespread global marketing network, new economic opportunities are presented to other producers and affiliates in host nations. The global production strategies of the majority of multinational firms

incorporate local producers and suppliers; therefore exposing their products and resources to new consumer markets. This exposure allows domestic firms and industries to potentially profit from their increased presence in the international economy (Oatley 2012: 174).

However, this is not always the case. Multinational corporations have the potential to negatively impact the domestic economy by overpowering locally dominated markets and pushing indigenous competing firms out of business. These potential negative externalities produce increased levels of risk among potential host nations. Because of the funding necessary to implement global operations, multinational firms can use their implied wealth to purchase domestic firms in order to eliminate competition (Frieden et al. 2010: 154). If not, multinational firms still remain advantageous over competition. Often times, multinational firms have the technological resources necessary to facilitate lower costs of production, giving them an advantage over domestic competition. As multinational firms expand their production capacity, established local firms will begin to lose sales to their low-cost, multinational competitor. In effect, the demand for locally produced inputs and resources will fall, driving indigenous suppliers out of business, resulting in a treacherous cycle of domestic firms being replaced by dominant foreign firms (Oatley 2012: 175).

Due to the absence of domestic savings and sovereign capital accounts, developing states are unable to finance governmental day-to-day services, public goods, and external indebtedness. FDI permits the transfer of savings of a firm to a host country, which provides developing nations with more capital to allocate to existing expenditures while also enabling nations to finance new development projects that result in economic expansion. The increase in available capital can also aid in the

stabilization of the host country's external indebtedness, which hinders the rate of economic growth and development (Drabek & Payne 2001: 5).

Once capital is transferred from a firm to a state after an investment venture, developing states could impose tight controls on capital due to the limited volume of their capital accounts. Capital controls are the measures taken by a state to limit the flow of foreign capital in or out of the domestic economy through volume restrictions, tariffs, and taxes. For example, firms may have difficulty finalizing investments or have their assets legally trapped inside the country by legislation or political red tape. Having said, capital controls of developing states are also prone to volatility and increase investor risk (Li & Resnick 2003: 193, 198).

The increase in capital can enable sufficient investments in new technology. Technological modernization benefits both the firm and the host nation. Advanced industrial economies have more innovative technologies that decrease the cost of production while simultaneously increasing production efficiency. The transfers and implementation of technology into the current production methods of overseas facilities decreases the overall cost to produce inputs for the multinational firm. The new technology has the potential to be transferred to the host nation's domestic producers, decreasing the cost of production and increasing manufacturing and sales (Oatley 2012: 174).

The transfer of technology is most commonly associated to investments involving the extraction of natural resources, such as in oil refinery or copper mining. The earliest multinational firms were motivated by potential profits from the extraction of large deposits of natural resources in developing countries. Multinational corporations often control substantial portions of natural resources in developing nations, especially in

host nations with extensive reserves of oil and copper. The presence of multinational firms increases the probability that they will have a significant role in influencing the allocation of the state's natural resources. This results in a shift of control in crucial sectors of the host nation's economy away from the government and toward multinational firms (Oatley 2012: 166).

Like technology, managerial expertise has the potential to be transferred to domestic firms and host country affiliates. The importation of managerial expertise plays a substantial role in a state's development. Operations in multiple countries distinguish multinational firms as better skilled in coordinating and organizing production and boosting efficiency. The labor force of the host nation can learn the management practices and apply them to other indigenous firms (Oatley 2012: 174).

The Uncertainties of Investment

The initial terms of the investment negotiation are crucial in order to ensure the positive externalities and ward off the negative effects of FDI. When two or more entities engage in negotiation, each participant has the explicit incentive to safeguard their personal interests. Investigating the protective measures of states and multinational corporations highlights the uncertainties of both parties in investment opportunities.

The widespread influence of multinational firms in the global economy can decrease the role of the host nation in economic activities. Multinational executives are more experienced in conducting negotiations due to their presence in the international economy. This grants them the ability to greater influence terms of investment with the less-developed regulatory bureaucracies of host nations. In effect, host nations have the

responsibility of protecting the crucial sectors of their domestic economy when initiating investment with multinational firms (Frieden et al. 2010: 156).

As previously discussed, multinational corporations propose investment opportunities to potential host nations. Firms want to decrease the role the host government plays in their business affairs so that they can operate self-sufficiently in the international economy. In order to do so, the state can tailor investment proposals to safeguard their interests. The firms outline stipulations of the investment that offer benefits to the firm such as discounted resources, tax breaks, and minimized regulation of business proceedings in exchange for long-term development projects, loans and other economic opportunities. Through decreasing the role of the state in the investment, firms can properly protect their assets, decreasing the probability that a host country will take its asset under direct control, also known as expropriation (Oatley 2012: 175).

Expropriation is the illicit seizure of a firm's assets by a governmental entity. In the event of an expropriation, the ownership and output of the asset is nationalized by the host government and brought under the direct control of the state. Assets with long-term value are more prone to expropriation because of its profitability to host governments. Besides economic gain, there are also political benefits to expropriating assets. Expropriating foreign direct assets gratifies the demand for social change and nationalism because it implies more control over firms operating within the domestic economy (Li 2005: 8). This is best exemplified by the nationalizations of authoritarian regimes in Latin America during the 1950s and 1960s. The political elites of these regimes rose to power on populist platforms that called for the redistribution of foreign held assets in the domestic economy (Tarzi 1991: 175).

Expropriating assets does not always guarantee political or economic prosperity. Foreign held assets can lose value amid expropriation if the multinational corporation imported managerial or technological expertise. The more integrated the asset into a particular corporate network, the less threat of host government takeover (Li 2009: 1106-7).

The deadlock between states and multinational corporations in negotiation emphasizes the importance of each party protecting their private agenda. In effect, this questions the motives and reservations of each party to pursue investment opportunities. Political scientist Nathan Jensen and other scholars have investigated the motivations for firms to proceed to invest in the developing world as well as identified and thoroughly dissected the uncertainties presented by both parties.

Jensen's research attempts to explain what actions governments and host nations can take to alleviate perceived investor risk. The bulk of Jensen's argument revolves around his idea that the biggest problem facing states and firms is the inability to ensure commitments and to guarantee the accurate transfer of information between negotiating parties. According to Jensen, it is necessary to understand the implications of the problems of commitment and information before developing a proper understanding of the allocation of foreign investment flows around the world (Jensen 2006: 3).

Commitment Problem

In the decision to expand a multinational corporation's affairs overseas, investors encounter certain obstacles when dealing with host nations in the developing world. One of the most prevalent obstructions is the anarchic state of the global economy. International law that could be used to uphold agreements between the private sector

and a host nation is non-applicable. States and firms that break contractual agreements are not held accountable by any international standard (Frieden 1994: 122).

Even though states want to receive FDI, multinational firms initiate investment opportunities by proposing the investment terms to a potential host nation. After agreeing to the terms, the majority of the bargaining power is transferred from the firm to the state because of their shifting preference to obtain greater shares of the investment, prompting a time consistency problem. For example, if a host nation is motivated to initiate investment because of its depleted capital accounts, their preferences are more likely to shift after capital has been successfully transferred from the firm to the state in order to finance the specified investment. The changing preferences of the state can also be attributed to the attraction to possible short-run benefits of the investment, which could potentially be more lucrative to government regimes in developing states. After achieving short-run benefits such as the immediate availability of capital, the host nation is incentivized to alter the long-run conditions of the investment with the firm (Tomz, 1997: 5).

Finding a way to arbitrate commitments is crucial in enforcing the stipulated terms of investment between multinationals and host governments. Because of the shifting preferences of the state after an investment has been initiated, investors face the inevitable problem of how to ensure that commitments will be upheld in the short and long run. In order to decrease the likelihood that states will alter the terms of agreements with multinational firms, a method of arbitration is necessary. Through commitment devices such as agreements via international institutions, states are able to increase credibility through the restriction of policy reversal by elevating the cost of going back on agreements (Tomz, 1997: 5). Firms and states can utilize the services of

international institutions to mediate agreements. Prominent international institutions, such as the World Bank and International Monetary fund are used as mediators can relieve investor risk. This promotes the legitimacy of the agreement between the firm and the multinational corporation in cross-border investment. Developing states that can showcase their ability to uphold commitments via international institutions have the opportunity to yield increased investment inflows (Buthe & Milner 2008: 758).

Committing to agreements with multinational firms has a direct reputational value for developing nations. Nations that decide to expropriate private assets suffer an undeniable setback to their international reputation. In the pursuit of attracting foreign investment, it serves detrimental for a nation to have an unstable history of expropriations of foreign-held assets. Nationalization directly increases the level of perceived risk and discourages investment because of its obvious unfavorable and adverse affects on multinational corporations (Jensen et al 2012: 4).

There are many examples of nationalizations and its negative reputational outcomes. A noteworthy and infamous example occurred in the early 1950s after Mohammed Mossadegh became the prime minister of the new democracy in Iran. Mossadegh's regime attempted to expropriate the refineries British-owned Anglo-Iranian Oil Company (now known as British Petroleum). This action led to a boycott of Iranian oil by the United Kingdom and its allies, which resulted in financial hardship for the Iranian government and citizenry (Tarzi 1991: 175).

Another incentive for states to uphold commitments with multinational firms is the attractive economic opportunities that spill over to other sectors of the state's economy. For example, FDI is complementary to trade agreements for developing states. Firms are able to incorporate their established trading networks into the host

nation's trade spheres. Through this process, Developing states are able to establish a broader sphere of trade with the presence of multinational corporations within their borders, directly increasing the state's economic potential (Buthe & Milner 2008: 758).

Information Problem

Another constraint to the initiation of foreign investment in international agreements is a mode by which information is released, relayed and processed between multinational corporations and their host nations. As Jensen's second problem with FDI, the information problem regards risk analysis and the availability of fiscal data as well as the state's political and economic policies to foreign investors. Compared to the commitment problem in investment, the information problem has received far less attention by Jensen and other scholars.

Information is crucial to foreign investors because it helps identify and potentially explain market and governmental peculiarities. Multinational firms headquartered in developed nations need to be cognizant of the implications of which their assets will be subjected. From market conditions to regional business cycles, investors value information pertaining to holding an asset in a foreign economy.

Proper assessments through risk analysis reports play a key role in a firm deciding to pursue investment opportunities. Risk analysis reports outline perceived investor risk by highlighting implications of a particular economy, sector or regime. Multinational firms investing in developing states are forced to supplement any information not provided by the government at their own expense, rendering transparent economic data to be cost-effective to investors. (Hollyer et al. 2011: 1202).

The absence of information about certain economies or markets insinuates increased corruption, or dishonest behavior of leaders or government officials. Actions

such as double-dealing, initiating closed-door transactions, diverting funds, taking bribes, and defrauding investors are considered corrupt practices, which could potentially be risky and costly to firms. By providing information to investors, states can properly introduce multinational firms to the methods and protocols in which the potential host nation conducts investment negotiations (Drabek & Payne 2001: 6).

Jensen's Assessment of Democracy

Jensen's published literature proposes that democracy is the necessary factor that remedies the inability of each party to uphold commitments and ensure the transfer of information pertaining to investment (2008). Democratic political institutions can provide market-friendly policies that showcase higher levels of credibility to investors. The democratic system of checks and balances as well as popular elections point reduce the probability of policy reversal and provides multinational corporations with a de facto commitment to policy stability. Jensen argues that the accountability of democratically elected officials results in reliable source of information about the domestic economy to investors (Jensen 2006: 1-3).

Published literature by Jensen (2003, 2008) proposes that democracy solves the problem of commitment between firms and states in FDI. According to Jensen, democratic governments decrease the political risks in investment through credibility and stability in the international political economy. Because of the accountability achieved through democracy, common policies such as institutional checks and balances, popular elections and the presence of veto players (a chamber of legislature, supreme court, and the separation of the executive and legislative branches of government) render democracies more liable to maintain commitments with investors in foreign investment agreements (Jensen 2003: 592-3).

Jensen explains that democracies foster a hospitable political climate for investors because of the eased ability to influence policy decision-making. Democracies allow for multinational investors to influence policy outcomes through lobbying or campaign contributions to politicians (Jensen 2008: 1050). Constituents have the opportunity to hold individual leaders politically responsible for policy changes in a democratic government. The economic benefits that accompany multinational investment incentivize democratically elected leaders to uphold contractual agreements with international firms. Through the means of accountability, the reputational costs of expropriation of multinational assets or breaking conditions of negotiations with firms is increased among constituents and can result in a politician losing his/her office (Jensen 2008: 1041).

Alongside the accountability and ability influence governmental policy, Jensen explains that investors are also comforted by various protectionist measures, unique to democratic regimes. Often times, democratic governments provide strong systems of protection, in areas such as property rights for multinational firms through different legislation or policy. Independent judiciaries and electoral challenges help to guarantee property rights protection legislation to secure assets in the long run, accumulating more attraction to invest (Li & Resnick 2003: 176, 203).

With proper protection and policies to ensure asset security, therefore, democratic regimes lower the levels of investor risk and create an increased sense of political and economic stability to investment firms. The lowered investor risk through democracy can be empirically tested, emphasized in Jensen's 2008 study that resulted in higher levels of investor confidence, which facilitated an increased inflow of foreign investment. According to Jensen, states with higher levels of democracy receive

increased amounts of FDI (Jensen 2008: 1050). Jensen supports his hypothesis by citing data on FDI in advanced industrial economies such as the United States.

Because of the representational responsibilities of democratic politicians, democratic regimes produce an overwhelming sense of political and economic openness. Jensen suggests that democratic regimes have an increased likelihood to release policy-relevant data at a higher rate than most autocracies because of the accountability factor. According to Jensen, democracy yields transparent economic policy because it is an outlet for constituents to hold elected executive and legislative officials accountable for their proposed policies and economic agendas. Democratic politicians are therefore incentivized to be transparent and use transparency as a tool for re-election by highlighting their accomplishments in office. The observation of increased levels of transparency in democratic regimes insinuates that transparency is a common byproduct of democracy (Jensen 2008: 1040-2).

Other studies, such as that of James Hollyer, B. Peter Rosendorff and James Raymond Vreeland (2011), have proven that democracies yield higher levels of transparency than nondemocratic regimes. In democratic regimes, the electorate values copious amounts of information. Because of the demand for increased information, democratic leaders are motivated to be open about economic policy and different facets of the economy in order to obtain votes to keep him/her in office. The availability, accuracy, and quality of economic data is driven by democratic political institutions that serve as a resource tool for citizens and domestic firms to gage market performance and domestic economic activities (Hollyer et al. 2011: 1202).

Limitations of Democracy

Contradicting Jensen's proposal that the presence of democracy can counter the

problems of investment, other scholars such as Quan Li and Adam Resnick (2003: 198) suggest that investors are actually comforted by the absence of democracy, speculating that states with recent transitions to democracy and states with higher levels of democracy have a negative impact on foreign investment inflows due to strict industrial regulation and voter-accountability of politicians.

Democratic states limit the oligopolistic and monopolistic behaviors of multinational firms through market regulation and the protection of domestic producers (Jensen 2003: 593). Protection of crucial sectors of the economy directly increases competition between multinational firms and domestic producers. The increased levels of democracy, therefore, could turn investors away from investing in democratic regimes due to the imposing constraints on the economy through regulatory measures and policies that favor domestic industrial protection (Li & Resnick 2003: 194-8).

The presence of democracy can potentially increase investor risk due to the ability of competing interest groups to influence government policy. Local firms represented by lobbying groups can influence politicians in a democracy because of their deep knowledge of local markets and other domestic producers. Because politicians want to appease their constituents, the knowledge of the domestic economy can be of high value to democratic politicians when drafting and ratifying economic policy. The democratic accountability of democratic regimes can limit the profitability and scope of multinational firms in the host economy (Jensen 2008: 1052).

Politicians can only be accountable to constituents while they hold public office. Term limits prevalent in democratic regimes can carry serious implications to multinational firms. In the democratic system, policy preferences required for electoral survival by individual politicians is volatile. The changing preferences of politicians

across different administrations can result in the altering or changing established economic policy by newly elected politicians, resulting in economic instability. Policy reversal in democratic regimes could be very harmful to the initial terms of investment outlined by multinational firms (Jensen 2008; 1042).

Multinational firms can be attracted to nondemocratic regimes because of the absence of term limits of elites, the lack of popular pressure from constituents as well as the ability to offer bribes and financial incentives to elites in exchange for cooperation or protection. Autocratic regimes can also entice investors with alternative benefits such as the repression of labor unions in an effort to lower wages and minimize labor standards. Lower wages and the absence of strict labor laws help reduce the cost of production for multinational corporations, increasing the attraction of multinational firms to autocratic regimes (Jensen 2006: 7).

Regardless of regime type, Jensen's problems of commitment and information in investment are still pertinent. Jensen's analysis of the problems accompanying investment, the high volume of information produced by democracy directly addresses the informational problem with investment. However, democracy as the answer to the information problem is not entirely accurate.

Critics of Jensen's claim that democracy solves the information problem, such as Daniel Kono (2006: 381-2) find that democracy produces complexity rather than transparency. Because consumers prefer liberal trade policies that lower prices and raise real income, democratically elected leaders should support liberal economic policy positions. However, democratic governments benefit financially from tariffs and trade barriers, funding government programs as well as politicians' salaries. Democratic politicians, therefore, are more inclined to utilize non-tariff barriers (NTB) because of

their lucrative value and ability to be opaque to the general public. “Core” non-tariff barriers encompass both price and quantity control measures, such as price caps, import licenses and quotas. “Quality” non-tariff barriers enforce product standards through labeling requirements, packaging standards, inspection, testing and certification. The majority of core and almost all quality NTBs are virtually overlooked by constituents because to the serious complexity of its terms. This tactic used by politicians is applicable to trade but it also speaks to the information problems in foreign investment (Kono 2006: 370-2).

Democratic politicians have the power to misuse transparency to distract their constituents. Providing too much information through transparent measures allows politicians to maintain a positive reputation among voters. By releasing extraneous information, politicians can cover up adverse economic policies. In order to overshadow negative outcomes of economic policies, politicians can overuse the level of transparency as a byproduct of democracy (Finel & Lord 1999: 320).

Due to the conflicting evidence against the notion that democracy provides investors with sufficient amounts of economic information, there are serious limitations when explaining democracy as the sole alleviator of the information problem.

Alternative Proposal: Transparency

The potential for increased economic activity that accompanies foreign investment has incentivized some developing states to remodel certain economic policies to increase foreign investment inflows. One of the mechanisms in which states increase investment is through the adoption of transparent economic and political policies. Developing states are subjected to an influx of external pressures from an overwhelming number of governments, multinational firms and international

institutions around the globe to adopt transparent political and economic policies to ensure the transfer of information. This trend among states, firms and institutions insinuates that the role of transparency is increasing in the decision-making process presented in investment ventures (Oatley 2012: 194, 200).

Because of the implicit economic and reputational benefits of investment, states are motivated to adopt transparent policies to address investor risk and ensure the availability of political and economic information. For example, access-to-information legislation attempts to address transparency by requiring industries, corporations and governments to publish vital economic statements and applicable legislation regarding their domestic economy (Hollyer et al. 2011: 1194). The presence of transparent policies provides clear reputational benefits that directly acknowledge investor risk by increasing the perception of a state's institutional quality. As a result of the reputational benefits, there is a growing and undeniable shift in investor preference toward fiscal transparency and openness when considering negotiating investment opportunities (Relly & Sabharwal 2009: 149).

Whether or not democratic or autocratic states adopt transparent policies, there is no international law that enforces access-to-information legislation. For example, a survey issued by the Bulgarian Access to Information Program Foundation in 2000 indicated that only 42% of Bulgarian administrators had effectively implemented Bulgaria's freedom of information legislation after its inception (Islam 2003: 13).

Instead, states are not required to disclose complete and accurate information regarding their economies. Because the desire for investment inflow in the developing world is relatively higher than in developed nations, developing states even have incentives to omit or fabricate economic data that is not conducive in attracting

investment. The process of excluding unfavorable economic data in various sectors is presented as a better substitute than altering data or disclosing accurate information to potential investors. Both the exclusion and the fabrication of economic data indicate the limitations presented with transparency (Hollyer et al. 2011: 1193). For example, in the mid 2000s, Greece “cooked the books,” or fabricated financial data by reporting overstated revenues amid their introduction into the Euro Zone, which resulted in a widespread financial crisis within the European Union (Spathis 2002: 179).

Transparency is understood to be an indicator of the overall capacity of a state to effectively govern its constituents. High levels of transparency produce positive perceptions of governance, stability and trust in a regime. Better governance is empirically linked with higher economic growth because of the ability of leaders to make better economic and political decisions. Evident transparency insinuates increased levels of trust and security among foreign investors, reducing risk and potentially increasing the likelihood of investment in that particular state (Islam 2003: 35-6).

CHAPTER 3

CENTRAL THEORY

The published literature on foreign investment has overlooked the importance and necessity of the transfer of information in investment. Previous scholars, as earlier mentioned, focus their research on presenting the steps to alleviate the uncertainties of commitment between participating entities in investment negotiations. After highlighting the oversights in the research of previous scholars on foreign investment and the negotiation process between states and multinational firms, my theory emerges. My theory represents an alternative, yet equally compelling, angle on alleviating the informational uncertainty presented through FDI.

Jensen's Problems of Investment

Jensen's proposed commitment and information problems in investment are pertinent to my central theory. However, Jensen's argument does not fully dissect his second problem of information in investment. His proposed solution of democracy to counter the commitment problem is acceptable but is inadequate and insufficient in terms of the overall ability to alleviate the full scope of the problem of asymmetric information. Autocratic regimes still receive investment inflows despite their inability to counter the commitment problem.

The information problem produces uncertainties about the trade-off distribution that benefits both entities. Democracy's inability to singlehandedly resolve the information problem is highlighted when examining the bargaining power. The bargaining power fluctuates due to the various incentives of both parties to work together in the initiation of investment.

Developing nations appear to have the critical advantage in the negotiations of FDI. The advantage takes the form of the state's ability to open its borders to firms and grant access to its domestic markets, labor pools and natural resources. At the same time, multinational firms also have a bargaining advantage because they possess the required capital, technology, managerial expertise and access to world markets that aid in the economic development of emerging nations. Thus producing a competition between firms and states for an upper hand in the bargaining process (Tarzi 1991: 169).

Evaluating the incentives of firms to invest in developing nations highlights the importance of the flow and availability of relevant and accurate information between multinationals and states.

Incentives to Engage in Investment Ventures

A firm's decision to invest abroad revolves around specific characteristics of the economic atmosphere surrounding the potential investment. Firms are more likely to invest where necessary resources and factors of production are abundant and inexpensive. Economists explain this phenomenon by using locational advantages as well as market particularities to explain why a multinational firm would decide to internationalize its operations and invest overseas (Oatley 2012: 165).

Locational advantages are derived from specific country characteristics that provide unique economic opportunities to firms, which are unavailable in their current operating facilities. Types of locational advantages include large quantities of natural resources, exposure to dynamic and growing local markets, and opportunities to enhance the efficiency of operations (Oatley 2012: 165).

The presence of large deposits of raw materials in a developing nation can be lucrative to multinational firms. It is through natural-resource investment that the

technological and managerial expertise of multinational is most valuable to developing nations. Often times, developing nations do not possess the technological or managerial expertise to properly or efficiently extract valuable resources such as petroleum, copper and aluminum. Multinationals can generate profit by providing states with efficient strategies and equipment to extract and allocate domestic resources throughout the world market (Tarzi 1991: 171).

Large and growing markets in developing countries provide multinationals with new avenues of business and broader consumer bases. Multinational firms initiate market-oriented investment strategies in an effort to capitalize on the new consumer bases of potential host nations. Multinational firms are more profitable without competition in consumer markets and the absence of competition serves as a critical factor of market-oriented investment. Firms can gain oligopolistic power through investment opportunities that enable them to monopolize their operations and have more supply and price control (Tarzi 1991: 170).

Tariff and nontariff barriers also motivate multinational firms to invest in developing states in an effort to avoid excessive expenditures in the international economy. By engaging in foreign investment, firms can dodge various import taxes to remain a major player in that particular economy. Circumventing these tariffs has the opportunity to further increase the scope of the multinational firm by utilizing trade agreements and treaties of the host nation. For example, throughout the 1990s, multinational firms in the automotive industry such as BMW, Honda, Nissan and Toyota, made direct investments in the United States in order to bypass export restraints that limited the number of automobiles imported into the United States (Oatley 2010: 167).

Firms are also motivated to expand their production overseas through efficiency-motivated foreign investment. This type of investment has the potential to decrease the overall cost of production by redistributing different stages of the production process to accentuate the factor abundance of particular countries. For example, multinational firms in sectors such as electronics demand low-skilled, labor-intensive production. To these firms, countries with abundant labor pools will have a competitive advantage over labor-scarce countries when considering where to invest (Oatley 2010: 167).

Like locational advantages, minimized market imperfections serve as a central motivation for firms to invest in developing countries. Market imperfections prevent firms from capitalizing and profiting on the locational advantages of an investment. For example, a firm reluctant to disclose patented production recipes or “know-how” information (both of which serve as ‘intangible assets’) has the incentive to internalize its affairs under a single corporate structure. Under a unified structure, firms can ensure that each production facility utilizes the intangible asset to its fullest ability while also benefitting from the locational advantages (Oatley 2010: 169).

Together, locational advantages and market imperfections, absent of political variables, are fundamental in the decision of firms to engage in foreign investment. Minimized market imperfections enable the firm to fully capitalize on the locational advantages in the potential investment by internalizing their activities under a united corporate structure. Through the process of negotiating investment, firms are required respond to the unique facets of the host nation’s economy and implement strategies that properly acclimate their presence in the new economy in which they will operate. As long as firms are able to produce a full evaluation and assessment of a potential host

economy, firms will embark on investment opportunities where market imperfections maximize locational advantages.

On the opposite side of investment negotiations, states have the incentive to initiate investment because of the positive externalities that stem from the presence of multinational corporations in their domestic economies. Like previously mentioned, states benefit from foreign investment because of the ability of firms to provide host nations with scarce factors of production through the transfer capital, technology and managerial expertise as well as access to new opportunities to domestic producers through the introduction to new global consumer bases (Oatley 2012: 158). These transfers of technology, managerial skills, capital and the exposure to markets through FDI significantly increase the bargaining power and economic potential of host nations.

Acquiescing control of various facets of their domestic economy can accelerate the progression of economic development in host nations. States can utilize the experience, technology and managerial expertise of multinational firms to potentially maximize economic potential and further develop dominant sectors of their economy. The desire for development incentivizes host nations to improve their administrative proficiency in areas such as international import and export compliance, taxation law, financial and industrial analysis as well as corporate accounting. By improving the expertise in these sectors, host nations can increase their surveillance of multinational firms operating within their borders. This improvement in leadership bolsters confidence within the state and provides effective control during the negotiation of the terms of investment with firms. This process directly increases a state's attraction to host multinational investment, implementing a virtuous cycle (Tarzi 1991: 169-71).

Like with multinational firms, competition affects the bargaining power of states. Increased competition among firms escalates the bargaining power of states in investment negotiation because of the heightened desire of multinational firms to have an operational presence in that particular nation. The power derived from multiple firms engaging in competition for investment opportunities gives states an upper hand to shop for the best possible investment package in terms of the direct benefits for the state. These benefits involve increased volume of capital accounts and outlines of extensive economic and physical development projects (Tarzi 1991: 172-3). The bargaining power is important to consider because of the tendency of the advantageous party to force the implementation of unequal agreements that may sow discord and erupt at a later period.

Information and Transparency

After examining the incentives of both parties to engage in the facilitation of FDI, the importance of information transfer becomes clear. Information is essential to firms and states in investment agreements. From the initial proposal to the implementation of investment, both parties engaged in negotiations benefit by conveying their incentives and motivations to invest in order to protect and foster a rewarding investment.

Information regards risk analysis on both sides of investment. For firms, information consists of outlines of a state's labor supply, economic policies, legislation, taxation, government spending and overall allocation of government resources. For states, information consists of outlines of all corporate activities of firms that will be implemented within their economy, such as detailed business models, projected development assistance along with other recompenses to the state. The more

information provided through various vehicles of transparency by both parties, the less uncertainty in investment.

The availability of information, or transparency is an essential element of foreign investment. The degree to which both parties are transparent has a significant effect on the probability of a firm to pursue investment opportunities. According to my theoretical model, transparency increases foreign investment by acknowledging and alleviating uncertainties of risk to investors. Transparent policies decrease investor risk by allowing investors to access and analyze accurate economic and political data of a potential host government.

Firms initiating foreign investment require relevant information regarding potential host countries because of necessary strategic planning. In an effort to effectively compose business strategies that maximize profitability through minimizing the cost of production, firms require necessary information about the potential host country's domestic economy. Firms can compile economic analyses of potential host nations from the information made available by the host nation, as posted through various governmental platforms. Transparent policy aids multinational firms in the generation of risk analysis reports because they are able to fully evaluate the climate of their potential investment. By providing multinational investors with full access to relevant legislation and economic policy, host nations show their initiative and willingness to comply with the terms of foreign investment by laying out the legal framework under which firms will invest.

Transparency also helps provide information that outlines governmental affairs and insight to how a particular nation conducts its business affairs. The consequences are severe for a state to expropriate a foreign held asset because of its adverse

reputational costs. Therefore, states with vehicles of transparency are less likely to expropriate foreign held assets because of the adverse reputational costs to future investors.

States can outline the boundaries in which the foreign investment will function by providing firms with appropriate information regarding its political and economic atmosphere. Multinationals benefit the host country's domestic economy by consuming the products and resources of local producers and exposing them to new consumer bases, therefore, incentivizing states to be transparent and open to multinationals during investment negotiations. States are enticed to showcase the prominent and inadequate facets of their domestic economy to firms because of the firm's ability to potentially bolster the state's economic development and profitability of domestic producers. Developing states can further accelerate economic development by increasing their credibility by conveying what is scarce in their economy to investors. By utilizing transparent means to inform multinational firms about the positive and negative components of its domestic economy, developing states can maximize the benefits of hosting foreign investment.

The availability of information is a major obstacle of both parties in foreign investment. Firms will invest where information is available and plentiful. My hypothesis is structured around my theory that transparency alleviates the information problem in investment; therefore, states with higher rates of transparency will receive increased FDI from multinational firms. As long as a state is transparent, the regime type should not be a divisive factor in the decision to invest. Transparency is driving investment alongside democracy, indicating that transparency serves as a separate variable when dissecting the relationship between transparency and democracy. The

degree to which a state is transparent is independent of the degree to which it is or is not democratic. Therefore, the type of government is not contingent in determining the level of informational transparency.

Democracy & Transparency Are Not the Same

Previous literature states that democracies yield higher levels of transparency than nondemocratic regimes because of the accountability of elected officials (Hollyer et al., 2011). While transparency is positively correlated with the presence of democracy² political scientist Daniel Kono (2006) argues that democratic governments are more likely to obscure policies that do not mirror popular opinion. The contradictory arguments lead to the notion that democracy and transparency are not the same.

Although transparency is a common byproduct of democracy, it is not solely dependent on the presence of democracy. Transparency acts as a distinct conceptual variable in analyzing the allocation of foreign investment. The degree to which a government regime is democratic and the extent in which that regime is transparent are not co-dependent. Autocratic regimes can be transparent and democratic regimes can be obscure. A noteworthy example is through the economic policy of Singapore, a very closed government regime that is known for its openness and frequent publishing of social and population census data, official audit reports of government agencies, election contributions and expenditures, national budget records as well as government loans and contracts (Article 19 2005: 62).

Because a state is considered “democratic,” does not mean that the government is required to be open about their domestic economy. Democracies can be equally, if not more obscure than autocratic states. Through various back-door policies,

² Empirically represented in **Appendices A & B**

democratically elected politicians have just as much incentive to withhold crucial market and economic information from their constituents and multinational firms to maintain electoral support. For example, the developing state of Mongolia is considered democratic according to its score of 10 on Polity IV scale. In terms of transparency, Mongolia ranks among the lower echelon of transparent states because of its mere 58% of reported statistics to international institutions according to the Hollyer et al. (2011) dataset on transparency.

Previous scholars agree that democratic regimes yield higher levels of investment because of the implied transparency in democracy. This finding implies that autocratic regimes are less transparent than their democratic counterparts. Autocratic elites are just as capable of establishing and maintaining transparent economic policy as democratic regimes. There are notable examples of developing, autocratic regimes exhibiting transparent economic policies with multinational firms, such as Belarus and Morocco. From 1996 to 2007, Belarus scored -7 on the Polity IV scale, indicating the absence of democracy. However, Belarus is considered transparent, reporting over 93% of economic statistics during the same time period. Morocco is another noteworthy example scored -6 according to Polity IV and reported an astonishing 99% of statistics from 1998 through 2007, rendering its status as transparent.

In regards to the problems faced in investment, democratic regimes have a clear advantage in attracting investment over autocratic regimes because of their ability to alleviate the commitment problem. Measures to alleviate the commitment and information problem increase the probability of investment through the reduction of investor risk. Since autocratic regimes cannot singlehandedly counter the commitment problem because of the absence of democracy but they can be transparent, the presence

of transparency must have a bigger impact in autocratic regimes. Therefore, the degree to which an autocratic state is transparent is more important in the eyes of investors than the degree to which a democratic regime is transparent.

Concluding Statement and Hypotheses

Evaluating the motivations of multinational firms and developing nations to engage in investment ventures and thoroughly examining the information problem provide adequate support for the framework of my research question: do developing states with increased levels of transparency attract more investment inflows?

The insufficient explanation of how to alleviate the information problem provides me with the framework of my argument. Transparency drives foreign investment in the developing world because of its ability to provide symmetrical information to both parties regarding each party's preferences, therefore, alleviating the information problem in investment. After taking into consideration the previous literature written on FDI, I have produced the following hypothesis: there is a positive correlation between increased inflows of foreign investment with the presence of transparent economic policies. In other words, the more transparent a state, the more foreign investment inflows they will receive.

My second hypothesis emerges from the ability of both democratic and autocratic states to be transparent. Investor risk is relieved through the adoption of transparent vehicles in both types of regimes. If democracy is acknowledged as the sole alleviator of the commitment problem, autocratic states are immediately disadvantaged in the competition for investment because they cannot overcome the commitment problem. However, autocratic regimes still receive investment flows. If transparency is driving investment and can counter the information problem, transparency must have a greater

impact on the investment flows of developing autocratic states. The presence of transparency is more beneficial to developing autocracies than that of developing democracies.

Although both of the hypotheses presented in this thesis concern transparency, I do not claim that transparency is the sole prerequisite of investment. Instead, I propose that transparency can better eliminate the informational uncertainty because of its ability to reduce risk by providing both parties with adequate information on different facets of the investment. I will empirically demonstrate that transparent economic policies have a noteworthy effect on increasing the likelihood of investment apart from its relationship with democracy in developing nations around the world. The next chapter details my research model, which will showcase the empirical analysis of both of the proposed hypotheses.

CHAPTER 4

METHODOLOGY AND RESEARCH DESIGN

In this section, I will measure transparency, democracy and foreign investment through the analysis of transparency scores, the degree to which a nation is democratic as well as the fluctuations of foreign investment inflows. My hypotheses and the correlation of my dependent variables can be formally evaluated through a quantitative analysis of ordinary least square regression in time series cross-sectional data in an effort to find a correlation between transparency and FDI inflows. My index of statistics used in the evaluation of my hypotheses is restricted to information pertaining to developing countries, which consists of any nation not an active member of the Organization for Economic Co-operation and Development (OECD).

First, I will discuss my dependent and independent variables necessary to evaluate my hypotheses. After, I will empirically evaluate the relationship between transparency and democracy as well as highlight their individual relationship with FDI. After, I will present the research model of both aforementioned hypotheses and showcase the regression results in order to explain the statistical significance of each variable. I will conclude this chapter by discussing the findings of my empirical analysis in terms of my central theory.

Description of Variables

The dependent variable of this hypothesis consists of FDI inflows over the gross domestic product (GDP) of a particular country, represented as FDI/GDP . GDP serves to normalize FDI flows. Comparing FDI inflows to a state's GDP aids in the formation of a common measurement between nations, relieving asymmetries in the sizes of

domestic economies around the world. I deem FDI/GDP to be the best possible dependent variable in the research models of both hypotheses because of its ability to generate consistent and comparable data about various states.

The independent variables consist of the lag dependent variable ($\beta_1 Y_{t-1}$), the degree to which a state is democratic (β_{2EI} Democracy), the degree to which a state is transparent (β_{3EI} Transparency), gross domestic product per capita (β_{4EI} GDP per capita), economic growth (β_{5EI} Growth), population (β_{6EI} Population), and standard error (Σ_t).

The lagged dependent variable is fundamental in both research models because I expect the current level of the dependent variable FDI/GDP to be heavily affected by its level in the previous year. The lagged variable consists of FDI/GDP at $t-1$. The lagged dependent variable also addresses concerns of autocorrelation.

The degree to which a state is democratic is measured using the standard 21-point Polity IV index. The index, which includes all major and independent states around the globe, ranks each state based on trends in global governance. The study measures the extent of executive recruitment, limitations of executive authority, and the legitimacy of political competition. Ranging from -10 to 10, countries with a ranking between -10 to -6 are considered autocratic while countries that score +6 to +10 are considered to be democratic (Marshall 2013).

Throughout my research, I came across various indices that empirically measure transparency such as that of Fry et al. (2000), which surveyed over 90 central banks from around the globe on a wide variety of topics such as methods of analysis, and institutional characteristics. Even though the survey produced a general transparency index based on its findings, it is inadequate for use in this thesis due to its insufficient

pool of respondents. Also, this index is not applicable to explain the transparency of the domestic economies of every developing nation; not every developing country has a central bank. For example, the establishment of a central bank is prohibited under the Panamanian constitution (Warf 2002: 37).

Instead, this thesis requires concrete data to analyze the extent to which developing states are transparent. For my empirical analysis, I will use a study published by James R. Hollyer, Peter B. Rosendorff and James R. Vreeland (2011) that determines a country's level of transparency based on the proportion of policy-relevant data distributed to international institutions such as the World Bank and International Monetary Fund. Hollyer et al. examined 172 variables of the World Bank's World Development Indicators (WDI) and coded the presence of missing data among 181 countries from 1960 to 2008. This study is measured in a similar fashion as democracy in Polity IV. The index is measured by the fraction of the 172 variables reported by a country in a given year. A country that does not provide any data for the WDI, is given a score of zero, while countries that report statistics on all 172 variables receive a score of 1 (Hollyer et al. 2011: 1197-8).

The World Bank compiles data submitted by national statistical agencies as well as international institutions such as the United Nations and the World Trade Organization. The World Bank's WDI index is a collection of over 800 sponsored and verified indicators on more than 150 different economies around the world. The WDI index includes national statistics of individual states on agriculture, aid, climate, the economy, education, energy, debt, gender, health, poverty, trade, etc. and chronicles their fluctuations as far back as 1960. For my thesis, I will utilize indicators of GDP per capita, population and growth. The World Bank discloses the official statistics on GDP

per capita and population. My growth variable, however, is expressed as a percentage of the current annual GDP growth minus the GDP from the previous year, divided by the GDP of the previous year.

Hypothesis 1 – Transparency in Investment

In order to statistically test my central theory that transparent, developing states receive increased foreign direct investment (FDI), I can utilize a time series cross-sectional data analysis, which will determine statistical significance among variables. Since transparency can be empirically measured, I can analyze its impact on FDI inflows alongside the degree to which a state is democratic, population, GDP per capita, GDP growth rate.

Research Model

$$\text{FDI/GDP}_{\text{EI}} = (\beta_1 Y_{t-1})_{\text{EI}} + \beta_{2\text{EI}} \text{Democracy} + \beta_{3\text{EI}} \text{Transparency} + \beta_{4\text{EI}} \text{GDP per capita} + \beta_{5\text{EI}} \text{Growth} + \beta_{6\text{EI}} \text{Population} + \Sigma_t$$

Table 4.1: Hypothesis 1 Results

Coefficients^a

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|----------------|-----------------------------|------------|---------------------------|--------|------|
| | B | Std. Error | Beta | | |
| 1 (Constant) | .033 | .005 | | 6.619 | .000 |
| Polity IV | .001 | .000 | .098 | 5.908 | .000 |
| Transparency | -.016 | .006 | -.047 | -2.830 | .005 |
| GDP per capita | 1.820E-14 | .000 | .042 | 2.050 | .040 |
| Population | -3.238E-11 | .000 | -.075 | -3.664 | .000 |
| Growth | .001 | .000 | .165 | 10.447 | .000 |

a. Dependent Variable: FDI/GDP

Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|-------------------|----------|-------------------|----------------------------|
| 1 | .194 ^a | .038 | .036 | .059 |

a. Predictors: (Constant), Growth, Transparency, Population, Polity IV, GDP per capita

The results of the OLS regression of the first hypothesis are showcased in **Table 4.1**. The “Sig.” column in the top graph indicates if there is statistical significance among variables (indicated by an alpha (α) level of 0.05). According to the results, the degree to which a state is democratic, the growth rate of GDP, population are statistically significant. For this hypothesis, however, I am mainly concerned with the transparency variable and its relevance to my dependent variable, FDI/GDP. Based on the results, transparency is slightly significant. In other words, the degree to which a state is transparent is empirically supported as a minor indicator of investment inflows behind the GDP growth rate, total population and the Polity IV score of a developing state.

The R-square value indicated in the lower table represents the proportion of variance in the data that is explained by the model. In other words, Polity IV, transparency, GDP per capita, population and rate of GDP growth explain 3.8% of the variation of FDI/GDP.

Hypothesis 2 – Autocracies and Transparency

I hypothesize that transparency is more beneficial to developing autocratic regimes because of their inability to overcome the commitment problem due to the absence of democracy. Therefore, transparency should have a greater impact on FDI inflows in autocratic regimes and reduce investor risk at a higher rate than transparent

democracies. Similar to the first hypothesis, I will conduct a time series cross-sectional analysis on developing democratic and autocratic nations to empirically evaluate my second hypothesis.

However, this hypothesis requires additional coding of variables. It is necessary isolate autocratic and democratic states in order to properly test this hypothesis. States with a Polity IV score less than -0.01 will be considered autocratic and greater than 0.01 will be considered democratic. I characterize each polity by a scalar $\Delta = [1,0]$ where 1 indicates the presence of democracy and 0 indicates autocracy. Through this method of coding, I can simplify the Polity IV score, which will aid in showcasing whether or not there is an increased dependency on transparency in developing autocratic regimes.

Research Model

$$\text{FDI/GDP}_{EI} = (\beta_1 Y_{t-1})_{EI} + \beta_{2EI} \text{Transparency} + \beta_{3EI} \text{GDP per capita} + \beta_{4EI} \text{Growth} + \beta_{5EI} \text{Population} + \Sigma_t + \beta_{6EI} \Delta$$

Table 4.2: Hypothesis 2 Results (Democracies)

Coefficients^{a,b}

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|----------------|-----------------------------|------------|---------------------------|--------|------|
| | B | Std. Error | Beta | | |
| 1 (Constant) | .115 | .013 | | 9.039 | .000 |
| Transparency | -.095 | .015 | -.155 | -6.510 | .000 |
| GDP per capita | 1.184E-14 | .000 | .013 | .470 | .638 |
| Population | -4.844E-11 | .000 | -.060 | -2.120 | .034 |
| Growth | .001 | .000 | .073 | 3.113 | .002 |

a. Dependent Variable: FDI/GDP

b. Selecting only cases for which democracy = 1

The empirical results of the second hypothesis displayed in **Table 4.2**, indicate statistical significance among the variables of growth and transparency in developing democracies. According to the unstandardized coefficient “B” column, the analysis indicates a negative effect of transparency on FDI. According to the table, increased transparency in developing democratic regimes is correlated with decreased investment inflows.

Table 4.3: Hypothesis 2 Results (Autocracies)

Coefficients^{a,b}

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|----------------|-----------------------------|------------|---------------------------|--------|------|
| | B | Std. Error | Beta | | |
| 1 (Constant) | .023 | .006 | | 4.105 | .000 |
| Transparency | -.006 | .007 | -.017 | -.892 | .372 |
| GDP per capita | 1.734E-14 | .000 | .035 | 1.357 | .175 |
| Population | -2.640E-11 | .000 | -.051 | -1.959 | .050 |
| Growth | .001 | .000 | .152 | 8.085 | .000 |

a. Dependent Variable: FDI/GDP

b. Selecting only cases for which democracy = 0

The second regression, **Table 4.3** shows the results of the regression for developing autocratic regimes. According to the table, growth is sole significant variable. Transparency has the least significance of all the variables. Similar to **Table 4.2**, the unstandardized coefficient B indicates a negative effect of transparency on FDI in developing autocratic regimes. Although both transparency coefficients in the second hypothesis are negative, the negative effect of transparency is smaller for autocracies than it is for democracies. While the empirical analysis indicates that transparency decreases investment in developing regimes, the fact that transparency reduces FDI

more in developing democracies than in developing autocracies serves as sufficient support for my second hypothesis.

CHAPTER 5

CONCLUDING ANALYSIS & ASSESSMENT

This thesis attempted to explain the ability of transparency to reduce investor risk and fully alleviate the informational problem of investment. The research offered throughout this thesis serves the purpose of determining the underlying prerequisites of the allocation of FDI. The analysis of key variables sought to explain the role of transparency to determine of which states will receive foreign investment.

Existing literature on FDI and its role in the developing world examines the potential externalities of investment, the measures taken by both firms and states to protect their interests and the underlying uncertainties faced by both entities during negotiation. However, the international political economy is anarchic and there are no mechanisms to enforce commitments and obtain information, which results in an informational and commitment problem.

After a formal review of the previous scholarship on the commitment and informational problem in investment and the role of democracy in each of the problems, my theory materialized. If democracy produces less risk by directly addressing both problems through political representation and accountability, why do autocratic regimes still receive investment inflows?

I proposed an alternative solution to the informational problem in investment ventures: transparency. Because transparency is not the same as democracy and autocratic regimes receive investment flows, democracy cannot singlehandedly alleviate the problems in investment. I have identified a clear and evident gap in existing scholarship on FDI and its relationship with vehicles of transparency.

I presented two hypotheses in this thesis: 1) transparency is driving foreign investment in the developing world and 2) transparency is more vital to autocratic regimes because of their inability to counter the commitment problem. Vehicles of transparency, via access-to-information legislation or the explicit disclosure of economic statistics are vital in countering the informational problem presented through the negotiation of foreign direct investment between multinational firms and developing nations.

The key insight from my theoretical model is that asymmetries in information inhibit both parties from profiting off the positive externalities that stem from foreign investment opportunities. However, through transparency vehicles, the incentives to pursue investment and its underlying uncertainties can be properly identified and acknowledged.

My empirical analysis tested the significance of transparency in the allocation of FDI around the globe, measuring the extent to which a state is democratic and transparent and its subsequent effects on the FDI inflows in terms of its gross domestic product (GDP). Because the byproducts of democracy are recognized as the most efficient means to ensure commitments, I also tested whether or not evident vehicles of transparency within autocratic regimes are more important in alleviating investor risk as compared to democratic regimes.

The statistical analysis presented in chapter four of this thesis concluded that the degree of transparency is not contingent on the presence of democracy in a particular developing state. The findings indicate that developing autocracies and democracies have similar advantages in the competition for investment.

In regard to my first hypothesis, the results of the regression show that transparency does, in fact, play a minor role in determining the allocation of foreign investment in the developing world. However, transparency was less significant than the GDP growth rate, population and the degree to which a state is democratic. My prediction of increased investment flows to transparent, developing states is supported by the linear regression models my first hypotheses.

The findings of the empirical analysis also support my second hypothesis regarding the increased impact of transparency in developing autocratic regimes. After isolating developing democracies and autocracies, I was able to test the significance of transparency in determining FDI in both types of regimes. The results indicated that transparency has a negative correlation with FDI. However, transparency decreases FDI more in democratic regimes, implying that transparency is more beneficial to autocratic regimes.

In summation, the presentation of my research indicates the importance of FDI inflows to developing countries. This indicates the importance of the initial negotiation of terms without proper mechanisms to ensure commitment and transfer accurate and symmetric information. By examining the relationship of transparency and FDI in the developing world, as outlined throughout the body of this thesis, I attempted to predict which states will receive FDI in an effort to decipher a trend throughout the international political economy.

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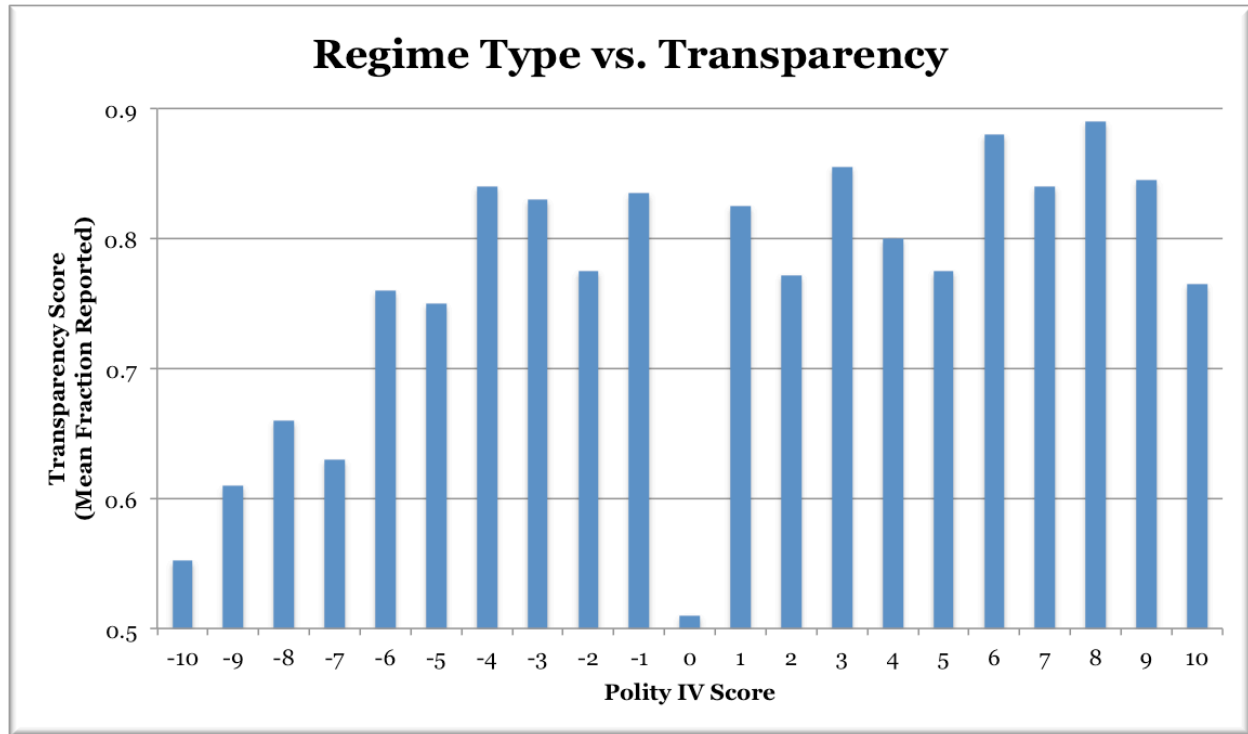
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Appendix A: Regime Type vs. Transparency



(Source: Polity IV and Hollyer et al. 2011)

Appendix A shows the level of transparency as compared to the type of regime. This graph indicates a low correlation between democracy and transparency. On average, non-democratic regimes (nations with a Polity score between -7 and -10) are slightly less transparent than democratic regimes (nations with a Polity score between +7 and +10) in terms of the amount of information reported to international institutions.

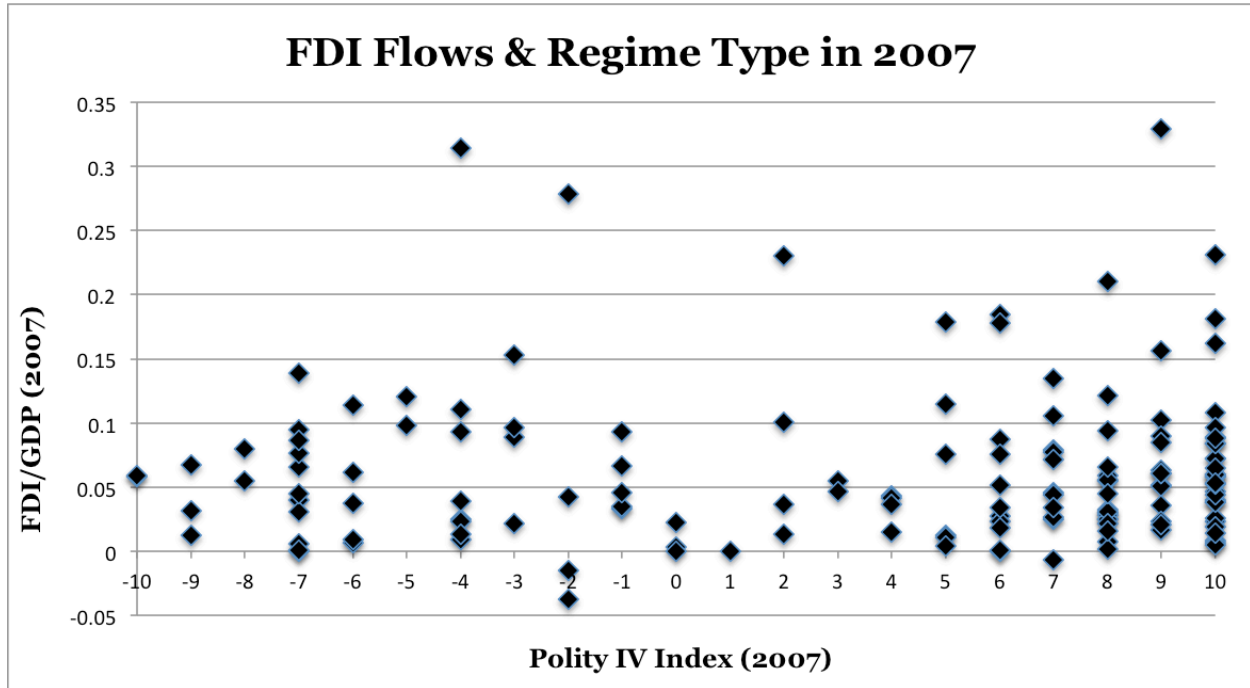
Appendix B: Polity IV vs. Transparency Score

| | Polity IV Code | Mean Transparency Score |
|------------------------------|---------------------------|------------------------------------|
| Non-democratic Regime | 0 | 0.695 |
| Democratic Regime | 1 | 0.811 |
| TOTAL | | 0.754 |

(Source: Polity IV and Hollyer et al. 2011)

Appendix B compares the mean transparency score between democratic and non-democratic regimes. Democratic regimes, on average, scored higher than autocratic regimes in terms of the ratio of reported data to international institutions. The difference between the mean values is a mere 0.116, indicating no statistical difference between the mean transparency scores of non-democratic and democratic regimes.

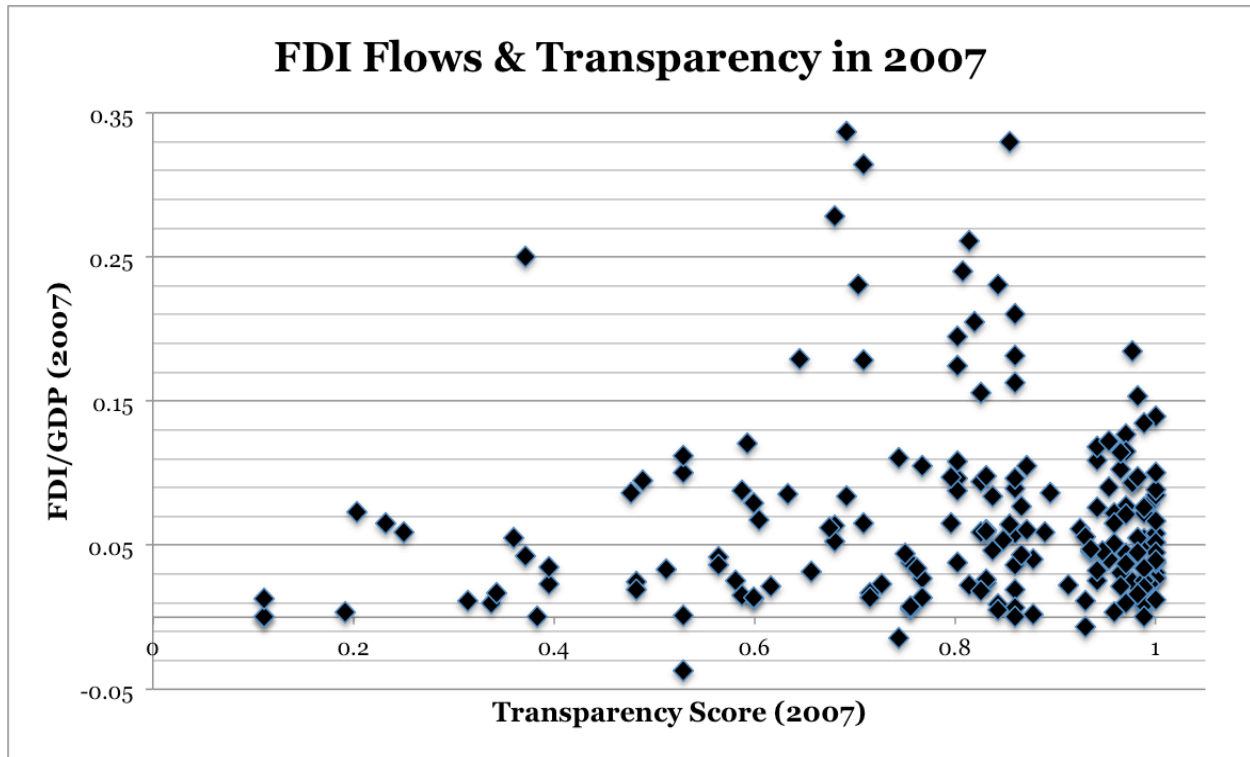
Appendix C: FDI Flows & Regime Type in 2007



(Source: World Bank 2014, Polity IV)

The graph indicated in **Appendix C** shows the FDI inflows based on the Polity IV score of developing states in 2007. From the graph, foreign investment flows appear to be equally distributed among democratic and non-democratic regimes.

Appendix D: FDI Flows & Transparency in 2007



(Source: World Bank 2014, Hollyer et al. 2011)

Appendix D highlights the investment inflows as a component of GDP based on the transparency score of both developed and developing nations in 2007. From the graph, the majority of FDI is concentrated in states that scored above 0.6 in the transparency index, indicating higher investment flows in transparent regimes.